MANAGEMENT'S DISCUSSION AND ANALYSIS

FISCAL YEAR 2012 OVERVIEW

The Department of Defense fields, sustains, and employs the military capabilities necessary to protect the United States and its allies and to advance our national interests. Key among America's interests is security, prosperity, broad respect for universal values, and an international order that promotes cooperative action.

Leon E. Panetta
Secretary of Defense

For FY 2012, the Department continued to shape its program based on the defense strategy expressed in the *2010 Quadrennial Defense Review* (QDR) report, a legislative-mandated review of DoD strategies and priorities. The 2010 QDR identified four priority objectives:

- Prevail in today's wars
- Prevent and deter future conflict
- Prepare to defeat adversaries and succeed in a wide variety of contingencies
- Preserve and enhance the All-Volunteer Force

To enhance the ability of U.S. forces to protect and advance U.S. interests in both the near- and long-term, the Department has focused on prevailing in today's wars and rebalancing military capabilities to prepare for an uncertain future. The Department also has sought to further reform our institutions and processes to better support the urgent needs of the warfighter; buy weapons that are effective, affordable, and truly needed, and ensure taxpayer dollars are spent wisely and responsibly. The 2010 QDR and the FY 2012 budget also address the Department's imperative to take care of its people. Much has been asked of the All-Volunteer Force and the civilians who have supported that force over the past decade, and, as a nation, we are obligated to take care of our people to the best of our ability.

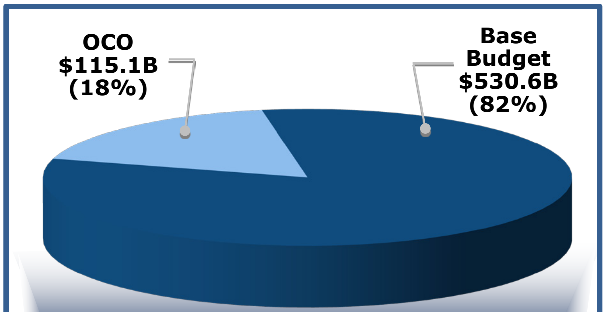
During FY 2012, the Department's enacted appropriations amounted to \$645.7 billion (Figure 2 depicts the composition of DoD's budget authority). The DoD FY 2012 budget was crafted to rebalance the priorities of America's defense establishment, institutionalizing successful wartime innovations to better enable success in today's wars while ensuring that our forces are prepared for a complex future. The funding enabled the Department to maintain readiness to conduct missions abroad and a full spectrum of training, combat training center rotations, and recruiting and retention efforts.

Figure 1. Mission

The Overseas Contingency Operations (OCO) resources enabled the Department to support and fund efforts primarily in Afghanistan and Iraq. The Department continued activities under Operation New Dawn (OND)/post-OND Iraq activities, as it worked to complete the military mission and the responsible drawdown of forces in accordance with the U.S.-Iraq Security Agreement and transition of authority, building on Iraq's improving security gains. In December 2011, the U.S. made good on its pledge to end the "advise and assist" mission in Iraq.

In Afghanistan, our goal remains to disrupt, dismantle, and eventually defeat al-Qa'ida and to prevent their return to either Afghanistan or Pakistan. U.S. coalition and Afghan forces have arrested the Taliban's momentum in much of the country and reversed it in several key areas. The last of the 33,000 surge troops sent to Afghanistan nearly two years ago to contain the Taliban insurgency have left the country. U.S. troops continue to work with Afghan National Security Forces and international partners and have begun the process of transitioning the lead for security to Afghanistan, which is scheduled to be complete across the country by the end of 2014. We also continue to apply relentless pressure to al-Qa'ida and other terrorist networks around the globe that threaten the U.S., its allies and partners, and our interests abroad.

Figure 2. Department of Defense FY 2012 Enacted Budget ($645.7B)



Budget by Appropriation	*$ in Billions*
Military Personnel	153.1
Operation and Maintenance	284.0
Procurement	120.6
RDT&E	71.9
Military Construction	11.3
Family Housing	1.7
Revolving Funds	3.1
Total	**$645.7**

B10-17

In addition, during FY 2012, the Department concluded its portion of the U.S. Government's support to the North Atlantic Treaty Organization (NATO)-led mission in Libya, Operation Unified Protector, to respond to Muammar Gaddafi's brutal behavior against the people of Libya. The U.S. Government and its international partners acted to mobilize a broad coalition, secure an international mandate to protect civilians, stop an advancing army, prevent a massacre, and establish a no-fly zone.

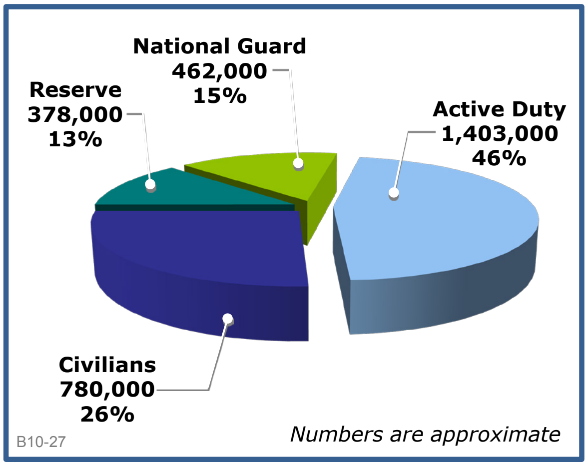
Also during FY 2012, the Department deployed approximately 100 U.S. military personnel to the areas of Central Africa affected by the Lord's Resistance Army (LRA). These military personnel advised and assisted the regional forces pursuing the LRA and its leadership, who have been indicted by the International Criminal Court. The Department also utilized its new authority, section 1206 of the FY 2012 National Defense Authorization Act (NDAA), to train and equip foreign forces participating in the effort to counter the LRA.

The Department's FY 2012 budget also looked ahead, continuing the process of rebalancing the capabilities of the Armed Forces to confront future threats. For example, the Department made investments to ensure that we can operate effectively in cyberspace and maintain resilient and reliable networks that can operate in contested environments. The defense program strengthened capabilities for projecting power, such as the long-range strike family of weapons systems. The FY 2012 budget also included funding to ensure that the U.S. nuclear posture continues to provide a safe, secure, and effective deterrent as we implement the *New START Treaty*.

The Department sought to further reform our institutions and processes--buying weapons that are effective, affordable, and truly needed, and ensuring taxpayer dollars are spent wisely and responsibly. We continue to invest in weapon systems and capabilities to counter 21st Century threats, support the workforce, and accomplish mission requirements and objectives. Development, modernization and recapitalization of equipment, focused on current and emerging threats, greatly improved combat capability. These new capabilities include the fifth generation Joint Strike Fighter, the Littoral Combat Ship, a new generation of ground vehicles, and many more weapons.

The FY 2012 budget also addressed the Department's imperative to take care of its people. Our workforce consists of more than three million employees, both afloat and ashore, deployed throughout the world to meet mission requirements. Nearly half of the Department's workforce is comprised of men and women on Active Duty. To provide Americans with the highest level of national security, the Department is staffed by approximately 1,403,000 men and women on Active Duty, 840,000 Reservists and National Guard members, and 780,000 civilians (Figure 3).

Figure 3. Staffing as of August 31, 2012



During FY 2012, the Department mobilized approximately 75,500 Reserve Component members at any given time. The men and women of the Reserve and National Guard provided security and assistance in both the Afghanistan and Iraq theaters and maintained aircraft in the Horn of Africa, to name a few of their many missions. The skills and capabilities of the Reserve Component members match current and anticipated DoD requirements, thereby reducing the stress on the total force while increasing the capacity.

All Active Components and five of the six Reserve Components met or exceeded their numerical accession goals for FY 2012. The Army Reserve finished 834 short for the year. This shortfall was the result of precision recruiting, which was implemented to balance the right mix of skilled personnel with the right set of requirements. All Active and Reserve Components exceeded recruit quality benchmarks in FY 2012 – a remarkable achievement. The Nation can be proud of these achievements as well as the commitment of Service members and their families, as reflected in record high retention rates.

A soldier uses his hand held radio to give a situation report to members of his company while other soldiers provide security during a dismounted foot patrol. The soldiers are assigned to the Michigan Army National Guard.

U.S. Army photo by Staff Sgt. Helen Miller

Throughout FY 2012, the civilian workforce continued to play a critical role in supporting the accomplishment of the Department's mission. In FY 2012, we witnessed their continued voluntary and enthusiastic participation in new and challenging roles, especially in support of the Department's wartime efforts. The *Civilian Expeditionary Workforce Program* has deployed volunteers to war zones to serve in career fields as diverse as intelligence, public affairs, policy development, financial management, and logistics. Thousands of civilians with in-demand expertise volunteer each year to support wartime missions in Afghanistan and Iraq. Before their one-year deployment begins, they first must undergo rigorous training at Muscatatuck Urban Training Center and at the Indiana National Guard Camp Atterbury Joint Maneuver Training Center, where they learn everything from cultural sensitivities to military customs and courtesies – with a few live-fire exercises thrown into the mix. The remarkable people who comprise civilian and military teams are the Department's greatest asset in providing a strong and agile national security force.

To protect the security of the U.S., the Department operates almost 16,000 aircraft, almost 600 ships, and many ground units. The Department's worldwide infrastructure includes more than 555,000 facilities (buildings and structures) located at more than 5,000 sites around the world on more than 28 million acres. These sites vary greatly in size. They range from the very small (an unoccupied site supporting a single navigational aid that sits on less than one-half acre of land) to the vast and immense, such as the Army's White Sands Missile Range in New Mexico with over 2.2 million acres, or the Navy's large complex of installations in Norfolk, Virginia.

The Department's FY 2012 resources also funded the construction and maintenance of additional modernized housing, both government-owned and privatized. In addition, the Department built schools for DoD dependents and medical facilities. The Department funded the operation of 254 commissaries and education for over 87,000 students in 194 schools.

The *Base Realignment and Closure* (BRAC) initiatives continued with $582.3 million in funding, which allowed the Department to provide environmental remediation and caretaker operations at properties not disposed of or handed over to local reuse authorities.

Even as we continued our strategic emphasis on prevailing in today's conflicts and rebalancing capabilities to prepare for future threats, in FY 2012 we continued an aggressive pursuit of efficiencies throughout the Department. The FY 2012 budget proposed more than $150 billion in savings from efficiencies, continuing initiatives begun in FYs 2010 and 2011. Recognizing the fiscal pressures the country is facing, in FY 2012 the Department launched a comprehensive effort – within the Military Services and in the Department as a whole – to generate efficiency savings by reducing overhead costs, improving business practices, and terminating lower priority or troubled programs. We redirected resources away from those programs and activities so that more pressing needs can be addressed.

The Department remains dedicated to obtaining, investing, and effectively using its financial resources to ensure the security of the U.S. and to meet the needs of both the warfighter and the ever-changing battlefield. The strategic placement of the Department's personnel, installations, and facilities is essential for protecting our homeland and national resources. These resources have never been more important than they are today as the U.S. fights terrorists who plan and carry out attacks on our facilities and our people. Taking care of our people, reshaping and modernizing the force, and supporting our troops in the field remain the highest priorities for the Department.

U.S. Army paratroopers and Afghan soldiers and policemen conduct a presence patrol in Afghanistan's Ghazni province.

U.S. Army photo by Sgt. Michael J. MacLeod

PERFORMANCE GOALS, OBJECTIVES, AND RESULTS

This section presents some of the key goal and measures that we use to assess our success in the Department of Defense.

DEPARTMENT OF DEFENSE STRATEGIC PLAN

The Quadrennial Defense Review (QDR) examines national defense strategy, force structure, infrastructure, budget plans, and other elements of the defense program, consistent with National Security Strategy, National Defense Strategy, and National Military Strategy. Consequently, the QDR Report constitutes DoD's Strategic Plan and forms the basis for development of the Department's Annual Performance Plan.

Figure 4. DoD Strategic Goals

In addition to the four QDR priorities--prevail in today's wars; prevent and deter conflict; prepare to defeat adversaries and succeed in a wide range of contingencies; and preserve and enhance the All-Volunteer Force--the QDR acknowledged that increased efficiency and effectiveness could be achieved by implementing an agenda that reforms how it does business. Consequently, these five reflect the Department's Strategic Goals. Strategic goals 1 through 3 reflect DoD's core warfighting missions, and Strategic goals 4 and 5 focus on DoD infrastructure support (Figure 4).

- Strategic Goal 1, "Prevail in Today's Wars," refers to the ongoing conflict and extended stabilization campaigns in Afghanistan and Iraq.
- Strategic Goal 2, "Prevent and Deter Conflict," focuses on integrated security cooperation and reorienting the Armed Forces to deter and defend against transnational terrorists around the world.
- Strategic Goal 3, "Prepare to Defeat Adversaries and Succeed in a Wide Range of Contingencies," indicates DoD's contributions to homeland defense, natural disasters, and other contingencies.
- Strategic Goal 4, "Preserve and Enhance the All-Volunteer Force," focuses on DoD personnel management, healthcare, and military families.
- Strategic Goal 5, "Reform the Business and Support Functions of the Defense Enterprise," focuses on improving and integrating DoD business operations to better support the warfighter.

Department of Defense (DoD) Performance Hierarchy

The FY 2012 Performance Plan, as updated in the FY 2013 President's Budget, reflects 5 overarching Department strategic goals, as well as 20 strategic objectives and 72 enterprise-level or DoD-wide performance goal priorities. The following section describes a representative sample of key strategic objectives and performance goals from the Department's FY 2012 Annual Performance Plan.

Primary responsibility for performance improvement rests with the Deputy Secretary of Defense in his role as the Chief Management Officer (CMO). The Principal Staff Assistants within the Office of the Secretary of Defense, in coordination with the Joint Staff, recommend the strategic objectives and performance goals determined to be the most relevant and of highest priority for DoD-wide management. The Department's strategic objectives and performance goals are subject to annual refinement based on changes in missions and strategic direction. Figure 5 shows that every level within the Defense Department is accountable for performance and results.

Figure 5. Department of Defense Performance Budget Hierarchy

FY 2012 Department of Defense Key Performance Results

The following tables, organized by DoD strategic goal and objective, depict 17 key performance measures for FY 2012. Unless otherwise stated, the results reflect progress through the third quarter and show that the Department is on track to meet 71 percent of these key performance goals for FY 2012 and will come close to meeting most other goals.

Strategic Goal 1: Prevail in Today's Wars

The Afghan National Security Force (ANSF) is the backbone of long-term security and stability plans for Afghanistan (Strategic Objective 1.1-OCO). The ANSF is on schedule to achieve its October 2012 surge end strength recruitment goal of 352,000, including the subordinate goals of 195,000 soldiers and 157,000 police. The ANSF has grown to a force of over 337,000, including 185,000 soldiers, 147,000 police and 5,500 airmen. As the Afghan National Army and the Afghan National Police have achieved growth goals, the ANSF and the North Atlantic Treaty Organization (NATO) Training Mission – Afghanistan (NTM-A) have shifted focus from force generation to training and development. The ANSF continues to develop into a force capable of assuming the lead for security responsibility throughout Afghanistan by the end of 2014.

STRATEGIC GOAL 1: PREVAIL IN TODAY'S WARS.				
Key Performance Measures	Strategic Plan Long-Term Performance Goals	Annual Performance Goals/Results		
		FY 2011 Results	FY 2012 Goals	FY 2012 3 Qtr Results
Strategic Objective 1.1-OCO: Degrade the Taliban to levels manageable by the Afghan National Security Force (ANSF), while increasing the size and capability of the ANSF.				
1.1.4-OCO: Cumulative number of Afghan National Security Force (ANSF) end strength	1.1.4-OCO: By FY 2012, the DoD will improve combat effectiveness by increasing the Afghan National Security Forces to 352,000.	306,903	352,000	■ 337,351

Goal 2: Prevent and Deter Conflict

Four performance results are key to satisfying the Department's deterrence missions and achieving its national security objectives. Our deterrent remains grounded in land, air, and naval forces capable of fighting limited and large-scale conflicts (Strategic Objective 2.1-1F1). The ability to successfully execute military operational plans is a core competency of the Department. By the end of the third quarter, the DoD Combatant Commanders were meeting all of their readiness goals and actually exceeding the DoD goal for being ready to execute contingency plans. In FY 2012, the Army completed the modular conversion of 228 of its 229 planned Multi-Functional and Functional (MFF) brigades, with the final MFF brigade activation scheduled for the fourth quarter of FY 2013. In addition, Defense Nuclear Surety Inspection results have consistently improved over the last four years

The USS Carl Vinson leads the USS Bunker Hill and the USS Halsey during a passing exercise with Indian navy ships during Exercise Malabar 2012 in the Indian Ocean.

U.S. Navy photo by Seaman George M. Bell and are currently achieving the desired goal of 100 percent first-time pass rate (Strategic Objective 2.2-1F2A). This is a positive indication of sustained Military Services' excellence and senior leader focus on the nuclear enterprise.

While the Department has fielded one more Aegis Ballistic Missile Defense (BMD)-capable ship today than it had in FY 2011 (Strategic Objective 2.3-1F3), the FY 2012 third quarter result (24 ships) falls significantly below the year-end projection (29 ships). By the end of calendar year 2012, 28 ships are scheduled for completion. Due to an austere budget environment, the Department reduced the number of funded Aegis BMD-capable ships to 31 through FY 2013. In the President's 2013 budget, the Department maintains funding for 36 BMC ship conversions through FY 2018.

STRATEGIC GOAL 2: PREVENT AND DETER CONFLICT.				
Key Performance Measures	Strategic Plan Long-Term Performance Goals	Annual Performance Goals/Results		
		FY 2011 Results	FY 2012 Goals	FY 2012 3 Qtr Results
Strategic Objective 2.1-1F1: Extend a global posture to prevail across all domains by increasing capacity in general purpose forces and by enhancing stability operations and foreign security force competency.				
2.1.2-1F1: Percent of the DoD Combatant Commanders' (CoComs) Contingency Plans which they report ready to execute	2.1.2-1F1: For each fiscal year, DoD Combatant Commanders (CoComs) will be ready to execute at least 80 percent of their Contingency Plans.	85%	80%	91%
2.1.4-1F1: Cumulative number of Army Multi-functional and functional Support (MFF) brigades converted to a modular design and available to meet military operational demands	2.1.4-1F1: By FY 2013, the DoD will convert 229 Army Multi-functional and functional Support (MFF) brigades to a modular design.	225	227	228
Strategic Objective 2.2-1F2A: Maintain a safe, secure, and effective nuclear arsenal to deter attack on the U.S. and on our allies and partners.				
2.2.2-1F2A: Passing percentage rate for Defense Nuclear Surety Inspections	2.2.2-1F2A: Beginning in FY 2011, the DoD will maintain a passing rate of 100 percent for all regular Defense Nuclear Surety Inspections.	85.7%	100%	100%
Strategic Objective 2.3-1F3: Strengthen cooperation with allies and partners to develop and field robust, pragmatic, and cost-effective missile defense capabilities.				
2.3.1-1F3: Cumulative number of Aegis Ballistic Missile Defense (BMD)-capable ships	2.3.1-1F3: By FY 2018, the DoD will have 43 Aegis ships that are BMD-capable.	23	29	24

Strategic Goal 3: Prepare to Defeat Adversaries and Succeed in a Wide Range of Contingencies.

A Navy Lieutenant carries a young girl to safety on Naval Air Station Joint Reserve Base New Orleans, Louisiana.

U.S. Air Force photo by Master Sgt. Dan Farrell

One key performance goal, carried over from FY 2011, is focused on establishing and certifying Homeland Response Forces (HRFs) at a response time of 6 – 12 hours (Strategic Objective 3.1-1F2B). The HRFs are operationally focused and aligned to the ten Federal Emergency Management Agency regions, and sourced by either a single state or a collection of states in that region. The HRFs, under control of the state governors, deploy in 6 – 12 hours with life-saving capabilities (emergency medical, search and extraction, decontamination, security, and command and control) supporting the needs of civilian agencies in response to chemical, biological, radiological, or nuclear incidents. By the end of FY 2012, the DoD had certified all ten HRFs located in the states of California, Missouri, Georgia, Pennsylvania, Ohio, Washington, Texas, New York, Utah, and Massachusetts.

STRATEGIC GOAL 3: PREPARE TO DEFEAT ADVERSARIES AND SUCCEED IN A WIDE RANGE OF CONTINGENCIES				
Key Performance Measure	**Strategic Plan Long-Term Performance Goals**	**Annual Performance Goals/Results**		
		FY 2011 Results	**FY 2012 Goals**	**FY 2012 3 Qtr Results**
Strategic Objective 3.1-1F2B: Improve the responsiveness and flexibility of consequence management response forces.				
3.1.1-1F2B: Cumulative number of Homeland Response Forces (HRFs) trained, equipped, evaluated, and validated at a reduced response time of 6-12 hours	3.2.1-1F2: By FY 2012, the DoD will have and maintain 10 Homeland Response Forces (HRFs) trained, equipped, evaluated, and validated at a reduced response time of 6-12 hours to a very significant or catastrophic event.	2	10	■ 8

Strategic Goal 4: Preserve and Enhance the All-Volunteer Force

The Department is on track to achieve three of four key performance goals that affect its ability to maintain an All Volunteer military. In the area of military health care costs (Strategic Objective 4.1-2M), outpatient prospective payment systems have yielded pricing reductions for private sector care as these are phased into full implementation. Pharmacy rebates provide reductions in retail pharmacy which is the highest cost pharmacy venue.

Less progress has been made in conversion to the Integrated Disability Evaluation System (IDES), which was completed in FY 2011 and is now used for all Service member disability evaluation processing. In this area, all Military Services report staffing shortages and information technology challenges. Mitigation measures include additional staff and actions to streamline medical and physical evaluation boards.

While the Services continue to meet their end strength goals for both Active and Reserve components, managing the deployment tempo remains a challenge (Strategic Objective 4.2-2P). In FY 2012, the Army made significant progress from 86 percent at the end of FY 2011 to 90 percent at the end of third quarter of FY 2012 for time deployed and time at home. In addition, the Department met its quarterly goal for civilian hiring for the first three quarters of FY 2012 and is on track to meet the annual, Federal-wide timeliness goal of 80 days for external hires. The use of USA Staffing has improved the Department's hiring timeliness and enabled human resource professionals to manage the end-to-end process more effectively.

Defense Secretary Leon E. Panetta, center, and Army Chief of Staff General Raymond T. Odierno, far left, pose for a photograph with the athletes of the 2012 Warrior Games in the Pentagon courtyard. The Warrior Games is an annual sporting event for wounded, ill and injured service members.

U.S. Army photo by Staff Sgt. Teddy Wade

STRATEGIC GOAL 4: PRESERVE AND ENHANCE THE ALL-VOLUNTEER FORCE.				
Key Performance Measures	Strategic Plan Long-Term Performance Goals	Annual Performance Goals/Results		
		FY 2011 Results	FY 2012 Goals	FY 2012 3 Qtr Results
Strategic Objective 4.1-2M: Provide top-quality physical and psychological care to wounded warriors, while reducing growth in overall healthcare costs.				
4.1.1-2M: Average percent variance in Defense Health Program annual cost per equivalent life increase compared to average civilian sector increase	4.1.1-2M: Beginning in FY 2007, the DoD will maintain an average Defense Health Program medical cost per equivalent life increase at or below the average healthcare premium increase in the civilian sector.	1.4%	</=0%	-8.3%
4.1.3-2M: Percent of Service members who are processed through the Single Disability Evaluation System (IDES) within 295 days (Active) and 305 days (Reserve) Components.	4.1.3-2M: By FY 2014, 80 percent of Service members will be processed through the IDES within 295 days (Active) and 305 days (Reserve) Components.	Non-applicable	60%	20%
Strategic Objective 4.2-2P: Ensure the Department has the right workforce size and mix, manage the deployment tempo with greater predictability, and ensure the long-term viability of the Reserve Component.				
4.2.3-2P: Percentage of the Department's active duty Army who meet the planning objectives for time deployed in support of combat operations versus time at home	4.2.3-2P: By FY 2015, 95 percent of active duty Army personnel will meet the deployment to dwell objective of 1:2.	85.7%	80%	90%
4.2.8-2P: Number of days for external civilian hiring (end-to-end timeframe)	4.2.8-2P: By FY 2012, the Department will improve and maintain its timeline for all external (direct hire authority, expedited hire authority, and delegated examining) civilian hiring actions to 80 days or less.	104	80	82

Strategic Goal 5: Reform the Business and Support Functions of the Defense Enterprise

The Department is on track to achieve five of seven key performance goals to improve business-related support across the Defense enterprise. However, the Department is under-executing its share of the Federal-wide initiative to reduce the number of data centers (Strategic Objective 5.2-2C).

An F-16 Fighting Falcon launches at dawn during a Peninsula Operational Readiness Exercise on Kunsan Air Base, South Korea. The exercise ensures service members are capable of performing their duties in wartime conditions.

U.S. Air Force photo by Staff Sgt Rasheen A. Douglas

Perhaps the most noteworthy result shows the average rate of Major Defense Acquisition Program (MDAP) cost growth (at 0.13 percent) – significantly below the annual FY 2012 goal of three percent (Strategic Objective 5.3-2E). However, the Department is not meeting its FY 2012 cycle time goal. Most of the programs in the portfolio of MDAPs starting in FY 2002 and after have experienced little or even, in some cases, negative cycle time growth. However, there are a total of 10 programs out of 28 in the measured population with cycle time growth exceeding five percent. Collectively, they result in the 6.26 average percent cycle time growth for the third quarter of FY 2012.

In the area of Major Automated Information System (MAIS) acquisition, the Department is meeting its goal to restrain the number of "critical" MAIS breaches to no more than two per year.

In the area of logistics (Strategic Objective 5.4-2L), all Military Services are meeting FY 2012 customer wait goals. The Army has made the most substantive improvement by reducing its average customer wait time by 13 percent (from 14.1 days in FY 2011 to 12.3 days at the end of the third quarter of FY 2012). This improvement was achieved by receiving materiel at selected sites through the nearest supply activity which allowed closing orders faster.

The Department relies on four key performance indicators or measures to assess its progress with regard to becoming audit ready. All of the measures are focused on the accuracy and reliability of the Department's ledgers, accounting systems, and associated financial reports. As of the third quarter (Strategic Objective 5.5-2U/V), the Department had exceeded its FY 2012 annual goals pertaining to the audit readiness of DoD mission-critical assets and for achieving audit readiness of DoD's Statement of Budgetary Resources (SBR) for Appropriations Received. An independent public accountant examination of the Defense Agencies' appropriations received will be completed in FY 2013.

STRATEGIC GOAL 5: REFORM THE BUSINESS AND SUPPORT FUNCTIONS OF THE DEFENSE ENTERPRISE.				
Key Performance Measures	**Strategic Plan Long-Term Performance Goals**	**Annual Performance Goals/Results**		
		FY 2011 Results	**FY 2012 Goals**	**FY 2012 3 Qtr Results**
Strategic Objective 5.2-2C: Protect critical DoD infrastructure and partner with other critical infrastructure owners in government and the private sector to increase mission assurance.				
5.2.2-2C: Cumulative percent reduction in the number of DoD data centers	5.2.2-2C: By FY 2015, the DoD will reduce its number of data centers by 45 percent (from 772 in FY 2010 to 428 in FY 2015) in order to increase data center storage utilization/capacity.	7%	19%	11.3%
Strategic Objective 5.3-2E: Improve acquisition processes, from requirements definition to the execution phase, to acquire military-unique and commercial items.				
5.3.2-2E: Average percent increase from the Acquisition Program Baseline (APB) cycle time for Major Defense Acquisition Programs (MDAPs) starting in FY 2002 and after	5.3.2-2E: Beginning in FY 2011, the DoD will not increase by more than five percent from the Acquisition Program Baseline (APB) cycle time for Major Defense Acquisition Programs (MDAPs) starting in FY 2002 and after.	4.5%	</=5%	6.3%
5.3.5-2E: Number of Major Automated Information System (MAIS) "critical" breaches (equal to or greater than 25 percent of Acquisition Program Baseline (APB) total cost or with schedule slippages of one year or more))	5.3.5-2E: By FY 2012, the DoD will ensure that the number of MAIS "critical" breaches (equal to or greater than 25 percent of Acquisition Program Baseline (APB) total cost or with schedule slippages of one year or more)) will not exceed two.	1	2	2
5.3.6-2E: Average rate of acquisition cost growth from the previous year for Major Defense Acquisition Programs (MDAPs) starting in FY 2002	5.3.6-2E: Beginning in FY 2012, the DoD will ensure that average rate of acquisition cost growth from the previous year for Major Defense Acquisition Programs (MDAPs) starting in FY 2002 does not exceed three percent.	-0.2%	3%	0.13%
Strategic Objective 5.4-2L: Provide more effective and efficient logistical support to forces abroad.				
5.4.2-2L: Army customer wait time	5.4.2-2L: By FY 2013, the DoD will maintain the Army's average customer wait time at or below 15 days.	14.1	15.5	12.3
Strategic Objective 5.5-2U/V: Improve financial management and increase efficiencies in headquarters and administrative functions, support activities, and other overhead accounts.				
5.5.3-2U: Percentage of DoD mission critical assets (real property, military equipment, general equipment, operating materials and supplies, and inventory balances) validated for existence and completeness	5.5.3-2U: By FY 2017, 100 percent of DoD mission critical assets (real property, military equipment, general equipment, operating materials and supplies, and inventory balances) validated for existence and completeness	4%	40%	41%

STRATEGIC GOAL 5: REFORM THE BUSINESS AND SUPPORT FUNCTIONS OF THE DEFENSE ENTERPRISE.				
Key Performance Measures	Strategic Plan Long-Term Performance Goals	Annual Performance Goals/Results		
		FY 2011 Results	FY 2012 Goals	FY 2012 3 Qtr Results
5.5.4-2U: Percentage of DoD Statement of Budgetary Resources (SBR) for Appropriations Received validated as audit-ready	5.5.4-2U: By FY 2013, the DoD will improve its audit readiness on the Statement of Budgetary Resources (SBR) for Appropriations Received to 100 percent.	80%	83%	■ 88%*
*Reflects August 31, 2012 (versus FY 2012 third quarter) status.				

All performance results for FY 2012 and associated trend analysis will be addressed in the Department's FY 2012 Annual Performance Report with the FY 2014 Congressional Budget Justification and will be posted at http://comptroller.defense.gov/ in February 2013.

Rigid-hull inflatable boats carry guests and sailors assigned to Special Boat Team 12 through San Diego Bay to an at-sea change of command in San Diego, California.

U.S. Navy photo by Seaman Geneva G. Brier

FINANCIAL OVERVIEW

FINANCIAL HIGHLIGHTS AND ANALYSIS

Ms. Teresa McKay, Director, Defense Finance and Accounting Service

The preceding sections provided an overview of DoD operations in FY 2012 and compared performance with goals. Meeting our defense goals requires resources. Our use of these resources in FY 2012 is summarized in the Department's financial statements, which appear later in this report.

The Department cannot yet produce financial statements that are auditable, and management cannot yet provide sufficient assurance of effective internal controls over financial reporting to pass an audit. This situation occurs because the Department currently cannot supply auditable documentation in a timely fashion and cannot demonstrate that its business processes are sufficiently reliable and well-controlled to pass an audit. The Financial Improvement and Audit Readiness initiative, discussed later in this report, is guiding the Department's effort to improve financial management and achieve audit readiness for key financial statements by 2014 and for all statements by 2017.

While the Department's financial statements are not auditable because of documentation and control problems, the underlying data are used regularly and successfully to pay people and vendors and to keep track of those payments. The data summarized in this section are providing the Department with the financial information necessary to manage its operations, including its wartime operations.

The principal financial statements have been prepared to report the financial position and results of operations of the Department, pursuant to the requirements of 31 U.S.C. 3515 (b). The statements have been prepared from the accounting records of the Department in accordance with OMB Circular No. A-136, and to the extent possible, U.S. Generally Accepted Accounting Principles (USGAAP) for Federal entities, and the DoD Financial Management Regulation. The statements, in addition to the financial reports, are used to monitor and control budgetary resources, which are prepared from the same records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

The Defense Finance and Accounting Service (DFAS) prepared the consolidated financial statements and explanatory notes, located in the Financial Information section of this report. The financial statements include:

- Statement of Budgetary Resources
- Balance Sheet

- Statement of Net Cost
- Statement of Changes in Net Position

STATEMENT OF BUDGETARY RESOURCES.

One of the most critical financial improvement and audit readiness priorities in the Department involves the processes, controls, and systems that support information most often used to manage the Department, namely, budgetary resources. The Statement of Budgetary Resources (SBR) presents the Department's total budgetary resources, their status at the end of the year, and the relationship between the budgetary resources and the outlays made against them. In accordance with Federal statutes and implementing regulations, obligations may be incurred and payments made only to the extent that budgetary resources are available to cover such items.

As discussed in the Overview section and depicted in Figure 2 of this report, the Department's FY 2012 enacted appropriations total $645.7 billion. The $42.3 billion decrease from FY 2011 enacted amounts is mostly attributable to a decrease in appropriations for overseas contingency operations (OCO). The amounts needed for OCO in FY 2012 were significantly lower due to completing the military and "advise and assist" missions in Iraq at the end of 2011, and the redeployment of approximately 33,000 troops from Afghanistan by the end of FY 2012.

The Department reported $1.2 trillion in FY 2012 total budgetary resources as summarized in Figure 7.

Figure 6. Trend in DoD Enacted Appropriations

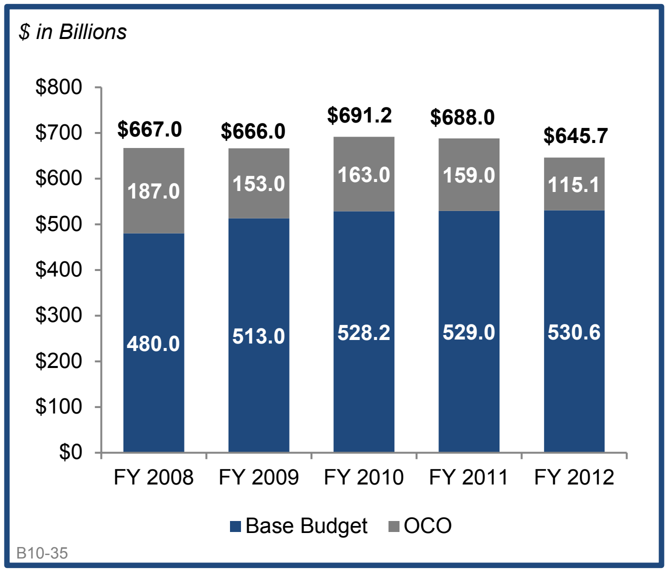


Figure 7. Composition of DoD Total Budgetary Resources

Description	FY 2012 *($ in billions)*
DoD Enacted Appropriations	$645.7
U.S. Treasury Contribution for Military Retirement and Health Benefits	76.8
Civil Works Projects Executed by the USACE	5.7
Trust Fund Receipts	125.3
Trust Fund Resources Temporarily Not Available	(61.3)
Total Appropriations Reported on SBR	**$792.2**
Brought Forward Unobligated Budget Authority	214.9
Spending Authority from Offsetting Collections	117.2
Contract Authority	80.5
Total Budgetary Resources	**$1,204.8**

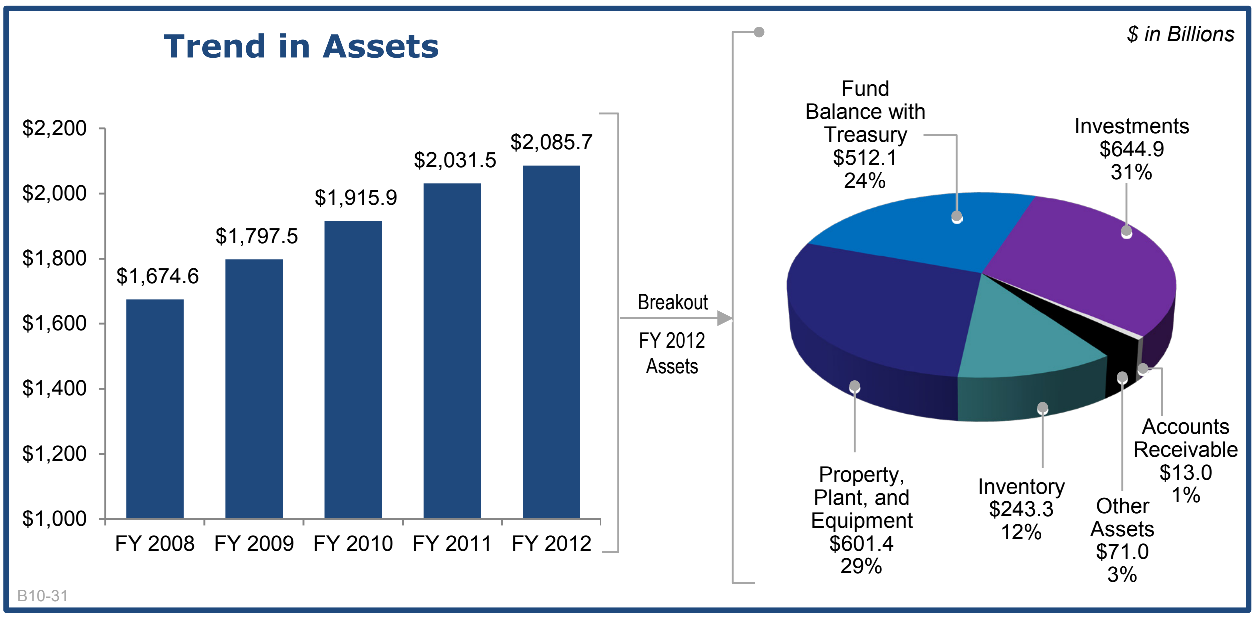
Total appropriations of $792.2 billion reported on the Statement of Budgetary Resources consist of enacted appropriations and appropriations that were provided by the U.S. Treasury for DoD retirement and health benefits. DoD also receives appropriations to finance the civil work projects managed by the U.S. Army Corps of Engineers. Current year trust fund receipts, to include the Military Retirement Fund and the Medicare Eligible Retiree Health Care Fund, are also included in the SBR "Total Appropriations" line. Trust fund receipts, labeled as "Temporarily not available," represent budget authority the Department will execute in future years to pay the current unfunded liabilities carried in these large funds.

Additional budgetary resources include $214.9 billion of unobligated balances brought forward from past years, $117.2 billion in spending authority from offsetting collections related to reimbursable work performed for public entities or other Federal agencies, and $80.5 billion of contract authority.

Of the $1.2 trillion in total budgetary resources, $1.059 trillion were obligated and $980.1 billion of obligations were disbursed. The remaining balance of unobligated budgetary resources relates to appropriations that are available to cover multi-year investment projects, which require additional time to procure. Additionally, appropriations that are expired for purposes of new obligations remain available for valid upward adjustments to prior year obligations.

BALANCE SHEET. The Balance Sheet, which reflects the Department's financial position as of September 30, 2012, reports amounts available to provide future economic benefits (Assets) owned or managed by the Department, the amounts owed (Liabilities) requiring use of available assets, and the difference between them (Net Position).

Figure 8. Summary of Total Assets



The $2.1 trillion in assets shown in Figure 8 represent amounts the Department owns and manages. Fund Balance with Treasury, Investments, and General Property, Plant, and

Equipment represent 84 percent of the Department's assets. General Property, Plant, and Equipment is largely comprised of military equipment, buildings, structures, and general equipment used to support the Department's mission requirements.

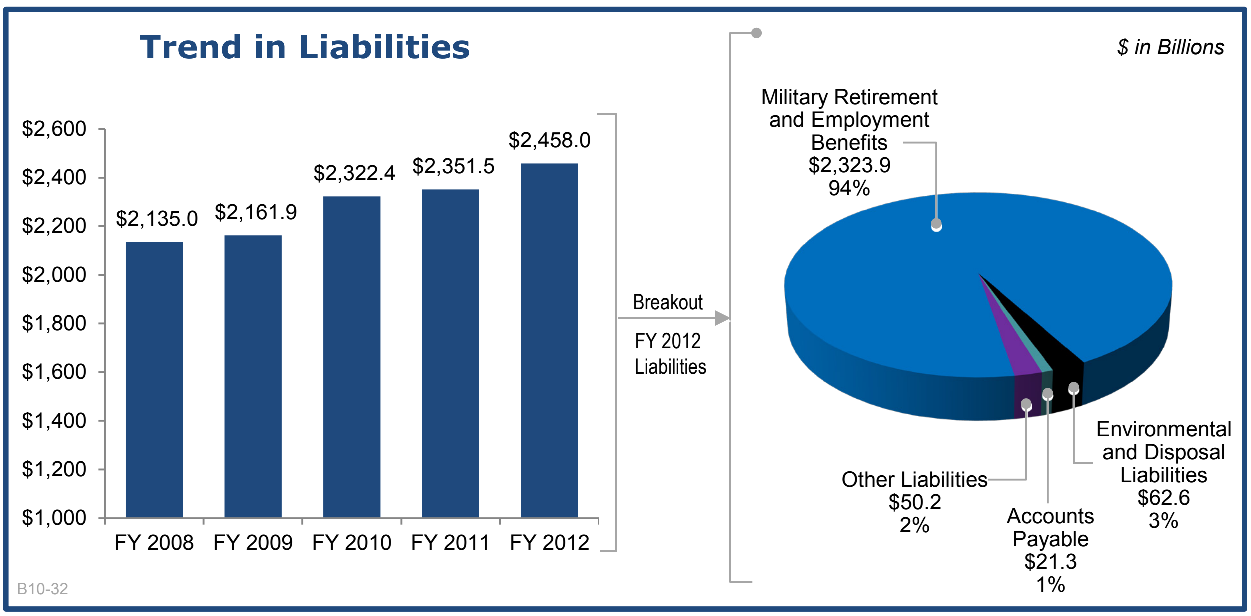
Assets increased $54.2 billion (3 percent) from FY 2011, largely due to increases in Investments in U.S. Treasury securities which were offset by decreases in the Department's General Property Plant and Equipment and Fund Balance with Treasury.

The $72.4 billion net increase in investments relates to the requirement to cover the expected normal growth of future military retirement and health benefits. Funds that are not needed to cover current benefits are invested in U. S. Treasury Securities. Under the Department's current strategy, invested balances will continue growing to cover the unfunded portions of future benefits.

The $11.3 billion reduction in the Department's Fund Balance with Treasury is largely related to the overall reduction in the FY 2012 defense budget.

The $7.9 billion decrease in the Department's General Property, Plant, and Equipment is largely the result of the ongoing efforts to validate existence and completeness and improve the valuation of its assets.

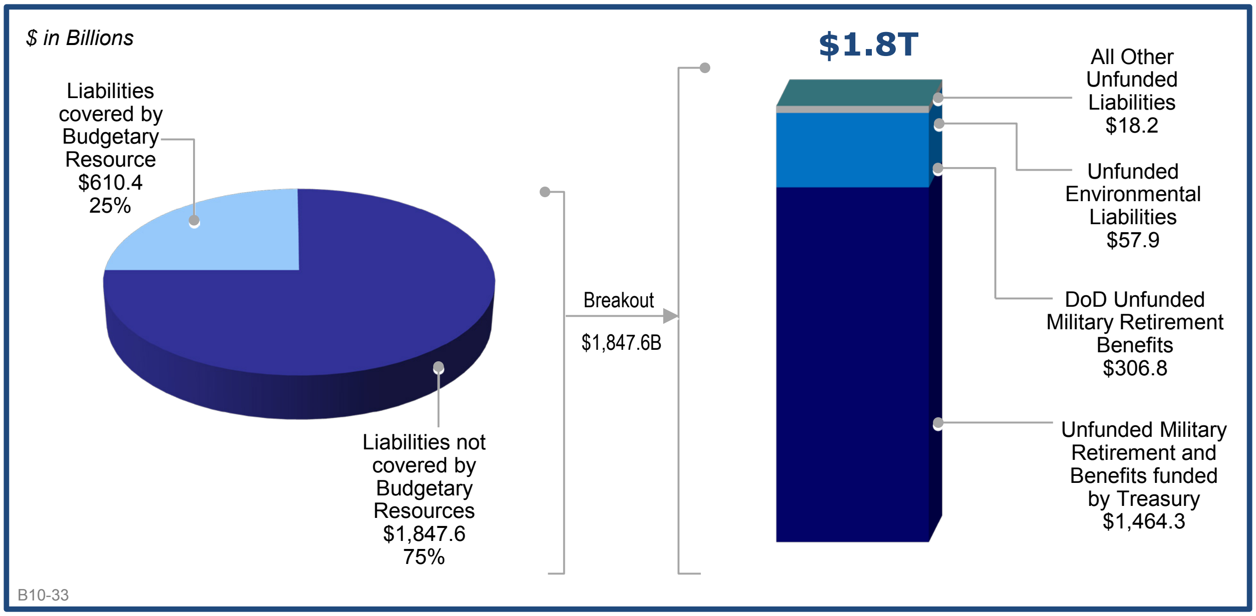
Figure 9. Summary of Total Liabilities



As seen in Figure 9, the Department's liabilities increased $106.5 billion during FY 2012, almost exclusively from normal growth in actuarial liabilities related to military retirement pension and health care benefits. The Department is confident in its ability to meet its financial obligations for the $2.5 trillion of liabilities reported in FY 2012.

Figure 10 identifies the unfunded liabilities that will require future resources. The U.S. Treasury is responsible for funding the actuarial liability that existed at the inception of the military retirement and health care programs. This actuarial liability accounts for approximately $1.5 trillion (79 percent) of the total $1.8 trillion in liabilities that are not currently covered by budgetary resources. Additionally, the Department has resources available to cover approximately $610.4 billion of the remaining liabilities, including funds primarily invested in U.S. Treasury securities.

Figure 10. Unfunded Liabilities

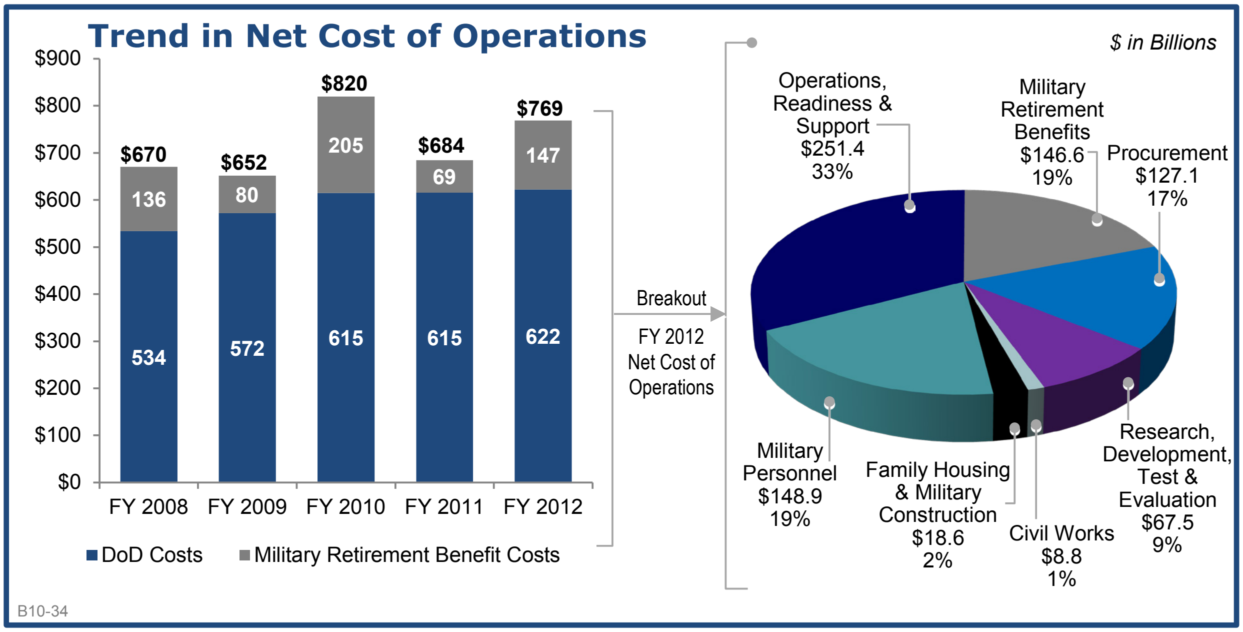


Net Cost of Operations. The Statement of Net Cost presents the net cost of all the Department's programs, including military retirement benefits. The statement reports total expenses incurred less the revenues earned from external sources to finance those expenses. Generally, the resulting balance of net cost is equivalent to the outlays reported on the SBR, plus accrued liabilities, less the assets purchased and capitalized on the balance sheet. Differences between outlays of budgetary resources and net cost generally arise from the timing of expense recognition.

The Department's costs incurred relate primarily to operations, readiness, and support activities, military personnel cost, and military retirement benefits. These costs were offset with investment earnings and contributions to support retirement and health benefit requirements, as well as earnings from reimbursed activities. This activity resulted in $768.9 billion in net costs of operations during the fiscal year.

As depicted in Figure 11, the $768.9 billion represents an $84.7 billion increase (12 percent) since FY 2011. The military retirement benefits accounted for $77.7 billion (92 percent) of the increase, which is largely due to changes in trend and other key assumptions used to calculate the liability for military retirement benefits.

Figure 11. Summary of Net Cost of Operations



The Department's financial performance is summarized in Figure 12. This table represents the Department's condensed financial position, results of operations, and budgetary resources, and includes comparisons of financial balances from the current year to the prior year. As previously noted, the lack of auditable financial data is a limiting factor in the ability of the Department to explain all material variances presented in the comparative statements. Nevertheless, the data underlying the amounts can be and is effectively used to manage the Department's operations in support of successful mission accomplishment.

Figure 12. Financial Performance Summary

Dollars in Billions

	FY 2012	Restated FY 2011	Change	% Change
ASSETS				
Fund Balance with Treasury	$ 512.1	$ 523.4	**$ (11.3)**	-2.2%
Investments	644.9	572.5	**72.4**	12.6%
Accounts Receivable	13.0	11.7	**1.3**	11.1%
Other Assets	71.0	72.0	**(1.0)**	-1.3%
Inventory and Related Property, Net	243.3	242.6	**0.7**	0.3%
General Property, Plant and Equipment, Net	601.4	609.3	**(7.9)**	-1.3%
TOTAL ASSETS	**$ 2,085.7**	**$ 2,031.5**	**$ 54.2**	**2.7%**
LIABILITIES				
Accounts Payable	$ 21.3	$ 28.0	$ (6.7)	-23.9%
Other Liabilities	50.2	46.3	3.9	8.4%
Military Retirement and Other Federal Employment Benefits	2,323.9	2,212.4	111.5	5.0%
Environmental and Disposal Liabilities	62.6	64.8	(2.2)	-3.4%
TOTAL LIABILITIES	**$ 2,458.0**	**$ 2,351.5**	**$ 106.5**	**4.5%**
TOTAL NET POSITION (ASSETS MINUS LIABILITIES)	**$ (372.3)**	**$ (320.0)**	**$ (52.3)**	**16.3%**
Total Financing Sources	$ 728.0	$ 758.2	$ (30.2)	-4%
Less: Net Cost	768.9	684.2	84.7	12.4%
NET CHANGE OF CUMULATIVE RESULTS OF OPERATIONS	**$ (40.9)**	**$ 74.0**	**$ (114.9)**	**-155.3%**
TOTAL BUDGETARY RESOURCES	**$ 1,204.8**	**$ 1,231.3**	**$ (26.5)**	**-2.2%**

FINANCIAL MANAGEMENT IMPROVEMENT INITIATIVES

In FY 2012, the Department carried out its mission even as it dealt with budgetary pressures. With further Defense cuts on the horizon, it is more important than ever for the Department to maintain the public's trust in our stewardship of taxpayer resources for the national defense. We are committed to improving defense financial management and providing the financial resources and business operations necessary to meet our national security objectives. The following initiatives highlight the Department's progress toward better financial management.

FINANCIAL FLEXIBILITY FOR WARFIGHTERS

The concept of financial flexibility means the ability to adjust priorities, identify financial resources, and make investment decisions quickly. In this context, "quickly" means realizing investment results within two years, which is much faster than the usual, deliberate budgeting process. The Department works closely with the Congress to address unanticipated capability shortfalls and balance the traditional acquisition risk areas of cost, schedule, and system performance through financial flexibility. In wartime, schedule slippage can cost lives. During active conflicts, the speed at which an urgent need is satisfied becomes the most relevant factor for reducing a commander's operational risk and for saving lives and maintaining tactical advantage.

Deputy Secretary of Defense Ashton B. Carter talks with soldiers assigned to 101st Airborne Division during a counter Improvised Explosive Device training exercise, at Fort Campbell, Kentucky.

DoD photo by Petty Officer 1st Class Chad J. McNeely, U.S. Navy

Since June 2011, the Department's Warfighter Senior Integration Group (SIG) has facilitated a flexible, agile approach for quickly identifying emerging urgent operational needs (UONS), and for rapidly adjusting program and budgetary priorities to fulfill UONS within an operationally relevant timeframe. The Deputy Secretary of Defense chairs the Warfighter SIG, which prioritizes actions and resources to resolve UONS. The SIG facilitates financial flexibility to better provide our forces with the best capabilities possible in the areas of force protection, command and control, counter Improvised Explosive Devices, and Intelligence, Surveillance and Reconnaissance.

The most flexible financing available to the Department are the accounts appropriated by the Congress for the Joint Improvised Explosive Device Defeat Fund, the Mine-Resistant Ambush-Protected Vehicle Fund, and the Commander's Emergency Response Program. For urgent needs beyond the scope of these appropriations, the Department uses other tools provided by Congress, such as the Rapid Acquisition Authority provided by Public Law 107-314, as amended, which results from the "Ronald W. Reagan

National Defense Authorization Act for Fiscal Year 2005." In addition, the Congress has authorized the use of Contingency Construction Authority to enable flexible use of military construction funds to build wartime facilities at combat outposts, forward operating bases, and airfields.

Also, the Department remains heavily dependent upon the transfer authorities granted by the Congress within the annual appropriations, which allow the Department to be more financially agile in a rapidly changing world. Within prescribed limits, the Department uses its authority to transfer funds within accounts to meet changing priorities. When those limits must be exceeded, the Department requests specific, above-threshold approval for each transfer from the congressional oversight committees.

Defense Secretary Leon E. Panetta gives the thumbs up during his launch sequence of an AV-8B Harrier Jet on board the USS Peleliu in the Pacific Ocean.

DoD photo by Erin Kirk-Cuomo

In FY 2012, transfer authority allowed the Department to accelerate selected programs and projects in response to the new Defense Strategic Guidance, positioning the Department to meet defense needs in the coming era. For example, the Department gained congressional approval to expedite the preparation of Bahrain-based patrol craft to defend U.S. Navy vessels against hostile fast attack craft.

The Congress provided additional financial tools for the Department when the Global Security Contingency Fund (GSCF) was created as a four-year pilot project by the FY 2012 National Defense Authorization Act (P.L. 112-81), Section 1207. The GSCF is jointly administered and funded by the Department of State (DoS), and the Department of Defense. The Department recently reprogrammed $21.8 million in support of security activities with partner nations across the globe. This newly created financial tool enables better cooperation among DoS and DoD activities for national security.

Finally, as part of its Strategic Management Plan, the Department's Chief Financial Officer tracks the time to process above threshold reprogramming requests. This metric provides a view of how well the Department supports its requests with the congressional oversight committees and responds to the needs of the warfighter for adjusting resources to meet evolving requirements. This year, the Department averaged 24 days – a 50 percent reduction from FY 2009 – to process and receive Congressional approval for UONS reprogramming.

In summary, financial flexibility gives the Department critical management tools to balance between available resources and urgent security needs to ensure that our Armed Forces can meet the demands of the U.S. National Security Strategy.

Financial Improvement and Audit Readiness (FIAR) Initiative

Although the Department's FY 2012 financial statements are not auditable, the Department is effectively managing and spending the dollars appropriated to it by Congress for the purposes intended. With only limited exceptions, the Department's dedicated financial management workforce pays DoD personnel, contractors, and other commitments accurately and on time, and also accurately records obligations and expenditures in the general ledgers of DoD financial systems. Failure in either of these responsibilities would result in unavoidable problems that would impact the warfighter and the Department's ability to accomplish its challenging, worldwide mission. The evidence shows that this is not happening.

U.S. Army World Class Athlete Program rifle shooter Sgt. Vincent Hancock won the Olympic gold medal in men's skeet after competing at the Royal Artillery Barracks in London during the 2012 Summer Olympics. The 23-year-old Hancock is assigned to the U.S. Army Marksmanship Unit.

U.S. Army photo by Tim Hipps

While we are confident that we effectively manage taxpayer funds, the Department currently lacks the ability to demonstrate reliable and well-controlled business processes, and to consistently provide supporting documentation in a timely manner to the auditors. These capabilities are required to successfully pass a financial statement audit. Part of the challenge lies with DoD's unique size and mission. Figure 13 shows the magnitude of financial activities processed by DFAS in FY 2012, excluding processing by other DoD entities, such as the U.S. Army Corps of Engineers (USACE) or TRICARE Management Agency (TMA).

Figure 13. FY 2012 Transactions Processed and Managed by DFAS

Description	FY 2012
Number of Active DoD Appropriations Managed	1,215
Number of Pay Transactions	164,900,000
Number of People/Accounts	6,600,000
Disbursements to Pay Recipients	$617,350,000,000
Number of Travel payments	7,100,000
Number of Commercial Invoices Paid	11,300,000
Military Retirement and Health Benefit Funds Managed	$631,200,000,000

Financial statement auditability is important to the Department for many reasons. It is required by law, but it also will validate that the Department is properly and effectively managing and executing the resources entrusted to it by Congress and the taxpayers. To better enable the Department to move toward auditable financial statements, the Department refocused its FIAR initiative in 2009 on the information most often used to manage the Department. With the change in focus, two financial improvement priorities were established: budgetary information (i.e., auditable SBR) and accountability of mission critical assets, validated by existence and completeness audits.

These priorities were codified by Congress in the NDAA of 2010, and in October 2011, Secretary Panetta directed that these priorities be an "all hands" effort and that SBR audit readiness be achieved in 2014. Secretary Panetta's message may be viewed at *http://comptroller.defense.gov/video_ts/secdefaccountabilitymsg.wmv*.

The Department's plan (the FIAR Plan) for achieving the goals of the FIAR initiative are presented in the *FIAR Plan Status Report*, issued on a semi-annual basis. The FIAR Plan addresses the issues affecting the reliability of DoD financial statements. Specific DoD Component near-term and long-term milestones, representing incremental steps toward audit readiness, are included in the *FIAR Plan Status Report*, as well as Component progress and accomplishments, metrics used to monitor progress, and deployment plans of Enterprise Resource Planning systems that are modernizing DoD-wide information systems. The report serves as the Department's annual Financial Management Improvement Plan, required by Section 1008(a) of the NDAA for FY 2002.

USMC aerial refueling operation.

U.S. Marine Corps photo by Cpl. Reece Lodder

Significant progress is being made to achieve audit readiness. We anticipate that in FY 2012, six Defense organizations will continue to receive unqualified audit opinions on their financial statements, and three additional organizations will receive qualified audit opinions (see Figure 14). In addition, the U.S. Marine Corps, the first Military Service to undergo an SBR audit, may receive positive results by the end of 2012. Also in FY 2012, the Department exceeded its audit readiness interim goal by achieving 88 percent (goal 83 percent) of auditability of its Appropriations Received, or funds distribution process. Also, 41 percent (40 percent goal) of existence and completeness assertions for the Department's mission critical assets will be either under audit or validated as audit ready.

Figure 14. FY 2012 Financial Statement Opinions

FY 2012 Unqualified Audit Opinions
U.S. Army Corps of Engineers – Civil Works
Defense Contract Audit Agency
Defense Commissary Agency
Defense Finance and Accounting Service
Military Retirement Fund
TRICARE Management Activity – Contract Resource Management
FY 2012 Qualified Audit Opinions
Defense Information Systems Agency – Working Capital Fund
Medicare-Eligible Retiree Health Care Fund
Office of Inspector General

Other important, incremental progress has been made on other key elements of the SBR and accountability of mission critical assets. As of the date of this report, 15 percent of the Department's budgetary resources are under audit. This percentage will significantly increase as the Navy plans to assert SBR audit readiness by the end of FY 2013, followed by the Army, Air Force, and other Defense organizations in FY 2014.

The Department manages the Managers' Internal Control Program (MICP), with the goal of providing instructions, guidance, and training on how to effectively execute an internal control program, enhance knowledge and understanding of audit readiness goals and priorities, and disseminate best practices and lessons learned. Additional information regarding the Department's MICP program is contained in the Systems, Controls, and Legal Compliance section and in Addendum A to this report.

Secretary of Defense Leon E. Panetta addresses soldiers deployed to Forward Operating Base Shukvani, Afghanistan.

DoD photo by Petty Officer 1st Class Chad J. McNeeley, U.S. Navy

Financial Management Workforce Improvement Initiative

The Department has initiated a Strategic Human Capital Plan process to ensure it meets DoD-wide civilian financial management workforce and lifecycle management needs. This multi-year effort, which is being applied across the Department's financial management civilian community, involves analysis of both manpower and position requirements.

In FY 2012, the Department established enterprise-wide, financial management competencies applicable to each financial management occupation. Based on these competencies, the Department has started action to implement a DoD Financial Management (FM) Certification Program to assist the FM workforce in meeting future needs and requirements. Goals of the Certification Program are to:

- Advance the professionalism of DoD's FM workforce
- Strengthen public confidence in the Department's financial management
- Improve skills and knowledge in audit readiness and decision support
- Leverage the benefits derived from implementing the Department's Enterprise Resource Planning systems
- Encourage career broadening and leadership training
- Establish a standard DoD FM body of knowledge

A U.S. pararescue crew hovers in an HH-60G Pave Hawk helicopter as part of a maritime personnel recovery exercise annual competition in Key West, Florida.

U.S. Air Force photo by Tech. Sgt. Michael Fuller

The new certification program will identify a required certification level (1, 2 or 3) for each civilian and military financial management position and within each certification level, a minimum number of training course hours will be required. The training is targeted to financial management technical competencies, DoD leadership competencies, and specific topics, such as audit readiness, fiscal law, and ethics. In addition to the training, a minimum number of years of financial management experience will be required for each certification level. Upon obtaining certification, a minimum level of continuing education credits will be required every two years.

The Department introduced pilot versions of this program for several Components this year, with large-scale implementation planned to begin in 2013.

Disciplined Use of Resources

In the FY 2012 budget submission, the Department proposed more than $150 billion in streamlining and efficiency goals for FYs 2012 – 2016, and we continue to monitor progress in implementing these changes. On May 15, 2012, Secretary Panetta recommitted the Department and its leadership to an effort initiated by his predecessor to look unsparingly at the DoD organization and its operations to establish more efficient, effective, and cost-conscious ways of doing business. Secretary Panetta emphasized that maintaining this focus is more important than ever, given the current fiscal environment, and he directed the Department to eliminate lower-priority programs, streamline support activities, and instill a culture of savings and accountability.

U.S. Marines conduct a battlefield zero on Camp Leatherneck in Afghanistan's Helmand province.

U.S. Marine Corps photo by Sgt. Keonaona Paulo

The Department continues to find further savings associated with streamlining overhead and headquarters, business practices and support activities. The Department is committed to aggressively seek ways to be more efficient, reduce costs, and be excellent stewards of taxpayer dollars while maintaining the ability to perform its mission. In FY 2012, the Department projected an estimated savings of $19.8 billion. Examples of a few of the FY 2012 efficiencies follow:

- <u>Navy Cuts Costs by Consolidating Wireless Contracts</u>. The Navy saved an estimated $10 million by consolidating numerous contracts with major carriers of wireless services, which enabled better pricing and "minute pooling."
- <u>Air Force Aircraft Uses Less Fuel</u>. The Air Force implemented and is implementing sixteen fuel saving initiatives that saved an estimated $45 million. For example, the Air Force is using commercial flight planning software to make real-time flight adjustments (airspeed, altitude) to save fuel. The Air Force also is reducing fuel reserves, consistent with safety and mission performance, in order to cut weight and save fuel.
- <u>Army Recruiting</u>. The Army saved an estimated $764 million by restructuring its recruiting and retention efforts in order to capitalize on the current and projected economic environments.

- Disestablishment of Joint Forces Command. The Department eliminated the Four Star Headquarters operation, along with redundant or non-essential functions and reassigned essential functions to other organization while scaling each remaining function to an efficient and appropriate capacity. This action resulted in estimated savings of $292 million in FY 2012.
- Business Transformation Agency (BTA) Disestablishment. The Department also eliminated the BTA, with critical functions reassigned to the Defense Logistics Agency, Washington Headquarters Services, and the Office of the Deputy Chief Management Officer, with savings estimated at $98 million in FY 2012.
- Health Care Costs Reduced by Responsibly Paying Hospitals for Outpatient Costs. The Department requested and won authority to use Medicare's Outpatient Prospective Payment Systems for reimbursing private sector institutions for outpatient care delivered to TRICARE beneficiaries, resulting in an estimated savings of $840 million in FY 2012.

A U.S. Air Force C-17 Globemaster III aircraft taxis to its parking spot on Bagram Airfield, Afghanistan. The Globemaster III is a regular visitor to Bagram Airfield, transporting troops, equipment and supplies in and out of the country.

U.S. Air Force photo by Capt. Raymond Geoffroy

SYSTEMS, CONTROLS, AND LEGAL COMPLIANCE

MANAGERS' INTERNAL CONTROL PROGRAM

The Department has a fundamental responsibility to be an effective steward of government money. Effective internal controls are the foundation of an organizational framework predicated on accuracy and accountability. Internal controls represent an organization's plans, methods, and procedures used to meet its mission, goals, and objectives, and serve as the first line of defense in safeguarding assets and preventing and detecting errors, fraud, waste, abuse, and mismanagement. The purpose of internal control is to provide reasonable assurance that an organization's objectives are achieved through (1) effective and efficient operations, (2) reliable financial reporting, and (3) compliance with laws and regulations.

The Department is responsible for establishing, maintaining, and assessing internal controls in order to provide reasonable assurance that it meets the objectives of the *Federal Managers' Financial Integrity Act*, Public Law (PL) 97-255, sections 2 and 4; the *Federal Financial Management Improvement Act*, PL 104-208; and the *Office of Management and Budget's Circular (OMB) No. A-127*, entitled "Financial Management Systems."

OMB Circular No. A-123, entitled "Management's Responsibility for Internal Control in the Federal Government," requires agencies and individual Federal managers to take systematic and proactive measures to:

- Develop and implement appropriate, cost-effective internal controls.
- Assess the adequacy of internal controls in Federal programs and operations.
- Assess and document internal controls over financial reporting and financial management systems.
- Identify deficiencies and necessary improvements.
- Take corresponding corrective actions.
- Report annually on internal controls through management assurance statements.

A U.S. Army Sgt. shares a high five with an Afghan boy during a presence patrol in Kabul, Afghanistan.

U.S. Army photo by Sgt. Catherine Threat

Based on the Department's assessment of internal controls, the Deputy Secretary of Defense has signed the following Statement of Assurance.

STATEMENT OF ASSURANCE

DEPUTY SECRETARY OF DEFENSE
1010 DEFENSE PENTAGON
WASHINGTON, DC 20301-1010

NOV 06 2012

The leadership of the Department of Defense (the Department) recognizes the importance of establishing and maintaining effective internal controls and financial management systems that meet the objectives of the Federal Managers' Financial Integrity Act (FMFIA), the Federal Financial Management Improvement Act (FFMIA), and Office of Management and Budget (OMB) Circular A-127, "Financial Management Systems." The Department continues to focus on strengthening the Managers' Internal Control Program, despite this resource-constrained environment, to exceed the objectives.

During this past fiscal year, the Department performed validations of select internal control programs. The purpose of the validations was to determine if the organization: (1) protected its resources against waste, fraud, and inefficiency; (2) ensured accuracy and reliability in accounting and operating data; and (3) complied with the policies of the organization. An independent assessment team provided the Components with written feedback for improvements.

The Department conducted its assessment of the effectiveness of internal controls over operations in accordance with OMB Circular A-123, "Management's Responsibility for Internal Control." Based on the results of this assessment, the Department can provide qualified assurance that its internal controls over the effectiveness and efficiency of operations and compliance with applicable laws and regulations achieved the objectives of the FMFIA, as of September 30, 2012. Details of the material weaknesses identified are available in Addendum A, "Other Accompanying Information."

The Department conducted its assessment of the effectiveness of internal controls over financial reporting in accordance with OMB Circular A-123, Appendix A, "Internal Control over Financial Reporting." This assessment determined that, while the Department continues to achieve measurable progress, it cannot provide reasonable assurance that internal controls over financial reporting were effective as of June 30, 2012. Related to this financial reporting assessment, as of September 30, 2012, the Department's financial systems are not in compliance with the FFMIA and OMB Circular A-127. Details of the material weaknesses also are available in Addendum A.

Improvements in the Department's financial processes remain the focus of the Department's Financial Improvement and Audit Readiness initiative and systems modernization efforts. The Department remains fully committed to a culture centered on an effective control environment.

Ashton B. Carter

The Department maintains and provides oversight of a Managers' Internal Control Program (MICP), led by the Office of the Under Secretary of Defense, Comptroller, to fulfill the responsibilities and requirements described above. Under the MICP, the Comptroller organization provides instructions, guidance, and training to:

- Share knowledge and insight with the Components on how to effectively execute an internal control program.
- Enhance the Department's knowledge and understanding of its audit readiness goals and priorities.
- Disseminate best practices and lessons learned, and assess the 32 DoD Components' internal control programs during on-site validations, designed to measure the progress of organizations as well as their strengths and challenges.

The aircraft carrier USS George Washington sails through calm seas near Guam at sunset while under way in the Pacific Ocean.

U.S. Navy photo by Petty Officer 3rd Class Paul Kelly

ACCOMPLISHMENTS

An internal control could be defined as a business practice, policy, or procedure that is established within an organization to create value or minimize risk. In most cases our focus is on reducing risk and addressing weaknesses, but organizational submissions by management also include accomplishments which, in the judgment of their Commanders, have created value by improving or strengthening the way we do business.

The following are highlights that reflect a few of the many improvements brought about through efforts to improve internal controls.

- Efficiency and Savings. The DFAS reorganized and implemented changes, beginning in October 2011, that will result in approximately $196 million in savings through FY 2017, to include the reduction of 395 full-time equivalents.
- Transportation and Cost Savings. The Defense Contract Management Agency (DCMA) Combat Support Center (CSC), during an internal control self-assessment of transportation costs related to deploying DCMA personnel, determined considerable cost savings could be achieved by maximizing the use of government versus commercial

U.S. Army paratroopers and Afghan soldiers patrol a village in the Tani district in Afghanistan's Khost province.

U.S. Army photo by Sgt. William Begley carriers. After considerable research and input from the DCMA Contingency Contract Administration Services (CCAS) Operations Team, deployed personnel, and DCMA Kuwait Operations personnel, the CSC developed, coordinated and posted the "Freedom Flight Policy" which directs all DCMA CCAS personnel to use Military Air transport for CCAS missions entering deployment and redeployment. Travel vouchers are certified and verified by CSC personnel ensuring Freedom Flights are utilized as required. In the first year since the inception of the Freedom Flight Policy, the Agency had an estimated $1 million in savings. The CSC continues to leverage the use of these non-commercial flights to achieve fiscal stewardship and cost savings within the Agency.

- Mobile Aircraft Fire Trainers (Force Readiness). Air Force firefighters are required to complete two live aircraft training exercises and a crew-based, issue-focused training event each year. The Air Force entered into a contract to obtain a five-year operational lease that provides two Mobile Aircraft Fire Trainers (MAFT) to serve four installations. The MAFT allows each installation to conduct crew-based proficiency training on an as-needed basis, ensuring firefighters maintain mandatory certification training and that the installation airfield meets annual Federal Aviation Administration certification criteria.

Air Force firefighters train with civilian firefighters from five locations to remove simulated victims from a burning aircraft on Francis S. Gabreski Air National Guard Base in Westhampton, New York. The airmen are assigned to the 106th Civil Engineering Squadron. Kellogg University provided the mock aircraft, which burned with propane at an estimated 1,200 degrees.

U.S. Air Force photo by Senior Airman Christopher S. Muncy

Additionally, sharing the MAFT between multiple installations is more cost effective than retaining permanent trainers at each location.

The Manager's Internal Control Program also plays a role in ensuring that these kinds of improvements are sustained and remain relevant to mission needs.

ASSESSMENT

The Department's management uses the following criteria to classify conditions as material weaknesses in internal control:

- Merits the attention of the Executive Office of the President and the relevant Congressional oversight committees;
- Impairs fulfillment of essential operations or mission;
- Significantly weakens established safeguards against waste, loss, unauthorized use or misappropriation of funds, property, other assets, or conflicts of interest;
- Constitutes substantial noncompliance with laws and regulations; or
- Represents nonconformance with government-wide, financial management system requirements.

Individual DoD Components issue assurance statements that assess and certify the effectiveness of internal controls. The Components' assurance statements serve as the primary basis for the Deputy Secretary's assurance statement on the effectiveness of the Department's entity wide internal controls. Information gathered from various sources serves as the basis for the assurance statements. This information includes management-initiated internal controls testing, program reviews, and evaluations. In addition, the IG DoD and the Government Accountability Office conduct reviews, audits, inspections, and investigations, and the findings are considered in the individual Component's assurance statements and provide the foundation for their individual assessments.

Members of coalition special operations forces wait for an air drop of supplies in the Shah joy district in Afghanistan's Zabul province. Such drops help resupply forces in remote areas of Afghanistan.

U.S. Navy Petty Officer 2nd Class Jon Rasmussen

The Department has effective processes in many key areas. As a result, there has been significant progress toward improving both financial and operational internal controls; however, it remains clear that the most daunting of challenges remain ahead, and more emphasis on effective and efficient operations is critical. In the upcoming fiscal year, the Department will continue to provide best practices and facilitate more validation assessments in order to meet the challenge.

MATERIAL WEAKNESSES

The Department's outstanding material weaknesses for FY 2012 are listed in Figure 15. Additional details related to the material weaknesses reported in the table, such as corrective action plans and timelines, are included in Addendum A, "Managers' Internal Control Program," of this report.

Figure 15. Department of Defense Outstanding Material Weaknesses

	Areas of Material Weakness	Number of Material Weaknesses	Year Identified	Component	Target Correction Year
1	Financial Reporting	18	FY 2001	Department-wide	FY 2017
2	Financial Management Systems	1	FY 2001	Department-wide	FY 2017
3	Acquisition	1	FY 2011	Department-wide	Reassessed annually based on incremental improvements
4	Communications, Intelligence and/or Security	4	FY 2006	OSD; Navy; Air Force; USAFRICOM	FY 2013
5	Comptroller and/or Resource Management	2	FY 2011	Department-wide	FY 2017
6	Contract Administration	2	FY 2006	Department-wide	Reassessed annually based on incremental improvements
7	Force Readiness	2	FY 2011	Air Force	FY 2013
8	Personnel and/or Organizational Management	3	FY 2006	Department-wide	FY 2015
9	Property Management	1	FY 2011	Department-wide	FY 2016
10	Supply Operations	1	FY 2011	Department-wide	Reassessed annually based on incremental improvements
	Total Material Weaknesses	**35**			

FINANCIAL MANAGEMENT SYSTEMS

The Department recognizes that to successfully meet our goal of achieving and sustaining improvements in financial management and auditable financial statements, we must improve our business systems. Our goal is to deliver a streamlined, 21st-century systems environment with information technology (IT) capabilities that work together seamlessly to support effective and efficient business processes and operations. Regrettably, our current business environment does not always meet these objectives. Many of our systems are old and handle or exchange information in ways that do not readily support strong financial management and audit standards and/or were focused more on budgetary rather than proprietary accounting standards. These IT systems tend to be non-standard, and sometimes do not include strong financial controls. Many of these legacy systems also do not record data at the transaction level, a capability that is essential to audit success.

To address these issues, the Department is pursuing improvements in its business systems environment by implementing modern, compliant systems and modernizing legacy systems when necessary and supported by a business case. The Department also is aggressively retiring legacy systems that are obsolete, redundant, or not aligned with our business objectives. Implementing modern technology solutions, a central part of our business systems modernization strategy, will directly enable key elements of auditability, such as: the ability to trace all transactions from source to statement and to recreate a transaction; documented, repeatable processes and procedures; demonstrable compliance with laws, regulations and standards; and a control environment that is sufficient to reduce risk to an acceptable level.

These improvements to our business systems are enabled by the advancements we are making in Business Enterprise Architecture, Business Process Reengineering (BPR), acquisition oversight, and investment management. Most recently, Section 901 of the FY 2012 NDAA introduced important changes to our investment management process, consolidating its execution and broadening its scope. To comply with this new law, the Department created a single Investment Review Board (IRB), chaired by the Deputy Chief Management Officer, that reviews the planning, design, acquisition, development, deployment, operation, maintenance, modernization, and project cost versus benefits of all defense business systems with total costs greater than $1 million across the current Future-Year Defense Program. This single, cross-functional IRB provides greater visibility of the IT investments planned for

An MH-60S Knight Hawk helicopter passes the USS Chafee while delivering supplies to the USS Vinson during a vertical replenishment mission with the USNS Bridge in the Pacific Ocean.

U.S. Navy photo by Petty Officer 2nd Class James R. Evans the business area and will better integrate business strategies with investment decisions. This greater understanding of our business systems environment will significantly aid our audit efforts. This IRB forum will help the Department to make better investment decisions, to ask the right questions when it comes to duplicative systems and the number of interfaces, and to reinforce the relationship of the business environment to the audit.

In accordance with Section 901 and in support of the single IRB, the Department also modified its existing business process re-engineering requirements. Over many years, the Department has taken a holistic approach to BPR to assess process weaknesses, identify gaps, and streamline and improve processes to ensure success in changes to the full spectrum of its business operations. The Department is fully integrating its BPR assessment process with its expanded investment management and oversight framework to make certain that BPR is conducted at the portfolio, end-to-end process, and system level. Conducting appropriate BPR will help the Department make wise investment decisions, improve its use of performance management, control scope changes, and reduce the cost of fielding business capability. The Department's updated BPR process provides a standard method for assessing and documenting efforts to support consistent compliance with BPR requirements. Financially auditable processes that use standard data will increase transparency and reduce the vulnerability of improper payments and potential fraud.

Improved systems alone, however, will not eliminate weaknesses or guarantee auditable statements. Achieving auditability requires consistent application of process controls across organizations and functional areas. Business and financial information that is passed from system to system must be controlled to ensure that only authorized personnel are using the system, that the systems protect data quality and integrity, and that a compliant audit trail is maintained. These processes must be controlled at the transaction level, from the source document to general ledger postings, accurate trial balances, and reliable period closeouts. Only by completing these steps can we prepare financial statements that can be cost-effectively reviewed and verified.

Additional information about the Department's defense business systems, including the plans for acquiring new systems and modernizing or retiring legacy systems, can be found in the statutorily mandated *Enterprise Transition Plan*. Further information about the link between these systems and the Department's auditability efforts can be found in the *Financial Improvement and Audit Readiness (FIAR) Plan*.

A U.S. Marine and an improvised explosive device detection dog search the perimeter of the Safar School compound.

Photo by Cpl Reece Lodder

MANAGEMENT CHALLENGES

U.S. Navy SEALs exit a C-130 Hercules aircraft during a training exercise.

U.S. Navy photo by Mass Communication Specialist Seaman Apprentice Anthony Harding

While we have made progress in FY 2012 in managing DoD financial resources, challenges remain. The Office of Inspector General works to promote efficiency, effectiveness, and integrity in the programs and operations of the Department.

Under the *Reports Consolidation Act of 2000,* the Agency Financial Report must include a statement, prepared by the Department's Inspector General (IG), that summarizes what the IG considers to be the most serious management and performance challenges facing the Department, along with a brief assessment of the Department's progress made in addressing those challenges. Detailed information regarding these challenges, along with the Department's management response, is included in the Other Accompanying Information (Addendum A) to this report.

The following lists the IG-cited management and performance challenges facing the Department:

- Financial Management
- Acquisition Processes and Contract Management
- Joint Warfighting and Readiness
- Information Assurance, Security, and Privacy
- Health Care
- Equipping and Training Iraq and Afghan Security Forces
- The Nuclear Enterprise

Detailed information regarding these challenges and the IG's assessment of the Department's progress, along with the Department's management response, is included in Other Accompanying Information (Addendum A) of this report.

PATH FORWARD

Over the last decade, the Department has undertaken extended operations in Iraq and Afghanistan to bring stability to those countries and secure our nation's interests. Even as these large-scale military campaigns recede, the U.S. still faces a complex and growing array of security challenges across the globe. Unlike past drawdowns, when often the threats that the U.S. faced were subsiding, the U.S. faces a strategic turning point due to the challenging and rapidly changing geopolitical environment amid difficult domestic fiscal circumstances. These challenges include the need to confront violent extremism around the globe; the proliferation of lethal weapons and materials; the destabilizing behavior of nations such as Iran and North Korea; the rise of new powers in Asia; and the new geopolitical landscape in the wake of the "Arab Awakening."

These challenges prompted the Department to begin a strategy-driven review in early 2011 to reshape our defense priorities and spending over the coming decade. This strategic review, an inclusive process throughout the Department, was guided by four overarching principles: maintain the world's finest military; avoid hollowing out the force; take the reductions in a balanced, strategy-driven manner; and preserve the quality of the All-Volunteer Force by ensuring that we do not break faith with our men and women in uniform or their families. The Department released a new Defense strategy in January 2012, "*Sustaining U.S. Global Leadership: Priorities for 21st Century Defense,*" that describes the tough choices the Department made to ensure that our Armed Forces have the capabilities and readiness they need while contributing to the nation's economic vitality.

President Barack Obama briefs the press on a new defense strategy as Defense Secretary Leon E. Panetta and Army Gen. Martin E. Dempsey, Chairman of the Joint Chiefs of Staff, prepare to offer remarks at the Pentagon.

DoD photo by Erin Kirk-Cuomo

The U.S. Armed Forces will remain capable across the spectrum of potential conflicts. We will continue to conduct a complex set of missions, ranging from counterterrorism and countering weapons of mass destruction to maintaining a safe, secure and effective nuclear deterrent and projecting power abroad. We will be fully prepared to protect our interests, defend our homeland, and support civil authorities. Going forward, the U.S. joint force will be smaller and leaner, but it will be agile, more flexible, ready to deploy quickly, innovative and technologically advanced. We will rebalance our global posture and presence, emphasizing the Asia-Pacific and the Middle East regions. We will continue to strengthen our key alliances, build partnerships, and develop innovative ways to sustain U.S. presence elsewhere in the world. We must be capable of successfully confronting and defeating any aggressor and have the ability to defeat more than one adversary at a time. And, even as we reduce the growth in the `overall defense budget, we will protect, and in some cases increase, our investments in technology and new capabilities as well as our capacity to adapt, mobilize, and grow the force if necessary.

Marines conduct immediate action drills during Exercise Lava Viper on Pohakuloa Training Area, Hawaii. The Marines are assigned to Gulf Company, 2nd Battalion, 3rd Marine Regiment. Lava Viper is a battalion-level, combined-arms training exercise to better prepare Marines for upcoming deployments.

U.S. Marine Corps photo by Sgt. Pete Thibodeau

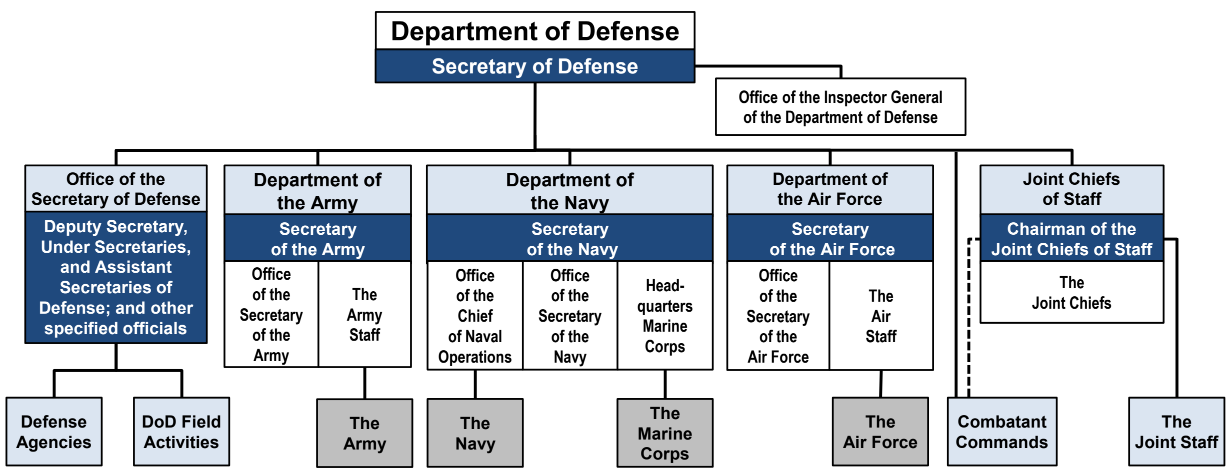
ORGANIZATION

Management of a large, complex enterprise like the U.S. Department of Defense requires an equally sophisticated organization. In keeping with the information typically presented in the Agency Financial Report, the following section briefly describes DoD's organization.

Since the creation of America's first army in 1775, the Department and its predecessor organizations have evolved into a global presence of more than 3 million individuals stationed throughout the world, dedicated to defending the United States by deterring and defeating aggression and coercion in critical regions. The Department embraces the core values of leadership, professionalism, and technical knowledge; its employees are dedicated to duty, integrity, ethics, honor, courage, and loyalty.

The Secretary of Defense is the principal assistant to the President in all matters relating to the Department of Defense and exercises authority, direction, and control over the Department. The *Department of Defense* is composed of the Office of the Secretary of Defense (OSD), the Joint Chiefs of Staff, the Joint Staff, the Office of the Inspector General of the Department of Defense (IG DoD), the Military Departments, the Defense Agencies, the DoD Field Activities, the Combatant Commands, and such other offices, agencies, activities, organizations, and commands established or designated by law, the President, or the Secretary of Defense.

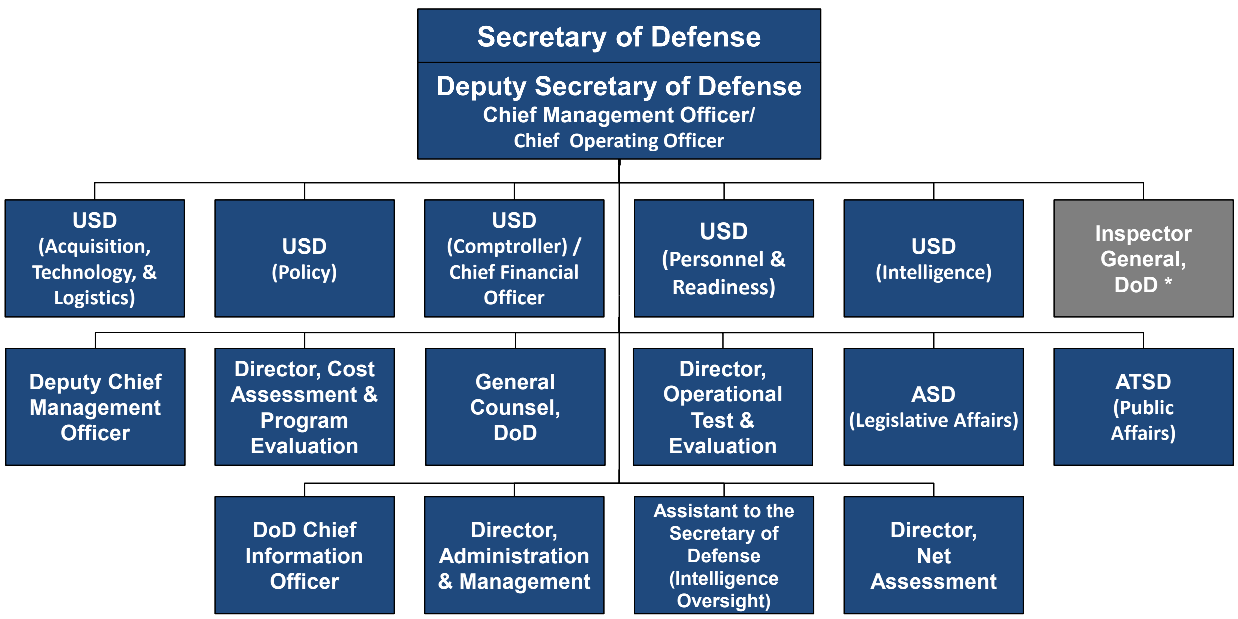
Figure 17. Department of Defense Organizational Structure



The Office of the Secretary of Defense

The function of OSD is to assist the Secretary of Defense in carrying out the Secretary's duties and responsibilities and to carry out such other duties as prescribed by law. The OSD Principal Staff Assistants (PSAs) are responsible for the formulation and oversight of defense strategy and policy. The OSD is comprised of the Deputy Secretary of Defense, who also serves as the Chief Management Officer; the Under Secretaries (USDs); the Deputy Chief Management Officer (DCMO); the General Counsel; the Assistant Secretaries (ASDs); the Assistants to the Secretary of Defense; the OSD Directors, and equivalents, who report directly to the Secretary or the Deputy Secretary; their staffs; the IG DoD; and such other staff offices within OSD established by law or the Secretary to assist in carrying out assigned responsibilities.

Figure 18. Office of the Secretary of Defense Organizational Structure



* *Although the IG DoD is statutorily part of OSD and is under the general supervision of the Secretary of Defense, the Office of the IG DoD (OIG) functions as an independent and objective unit of the Department of Defense*

The Joint Chiefs of Staff and The Joint Staff

The Joint Chiefs of Staff, supported through the Chairman by the Joint Staff, constitute the immediate military staff of the Secretary of Defense. The Joint Chiefs of Staff consist of the Chairman, the Vice Chairman, the Chief of Staff of the U.S. Army, the Chief of Naval Operations, the Chief of Staff of the U.S. Air Force, the Commandant of the Marine Corps, and the Chief of the National Guard Bureau. The Joint Chiefs of Staff function as the military advisors to the President, the National Security Council, the Homeland Security Council, and the Secretary of Defense.

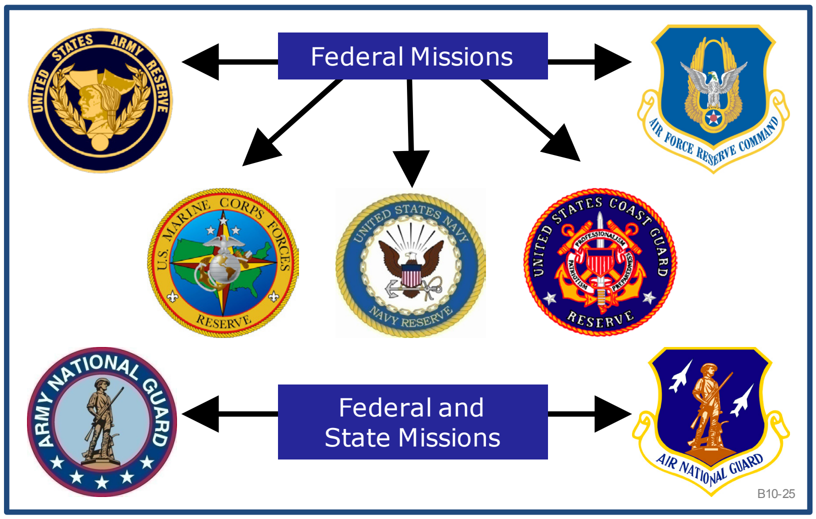
Office of the Inspector General

The Office of the IG DoD is an independent and objective unit within DoD that conducts and supervises audits and investigations relating to the programs and operations of the Department.

Military Departments

The Military Departments consist of the Departments of the Army, the Navy (of which the Marine Corps is a component), and the Air Force. Upon the declaration of war, if Congress so directs in the declaration or when the President directs, the U.S. Coast Guard becomes a special component of the Navy; otherwise, it is part of the Department of Homeland Security. The three Military Departments organize, staff, train, equip, and sustain America's military forces and are composed of the four Military Services (or five when including the U.S. Coast Guard when directed). When the President and Secretary of Defense determine that military action is required, these trained and ready forces are assigned to a Combatant Command responsible for conducting military operations.

Figure 19. Reserve Forces and National Guard

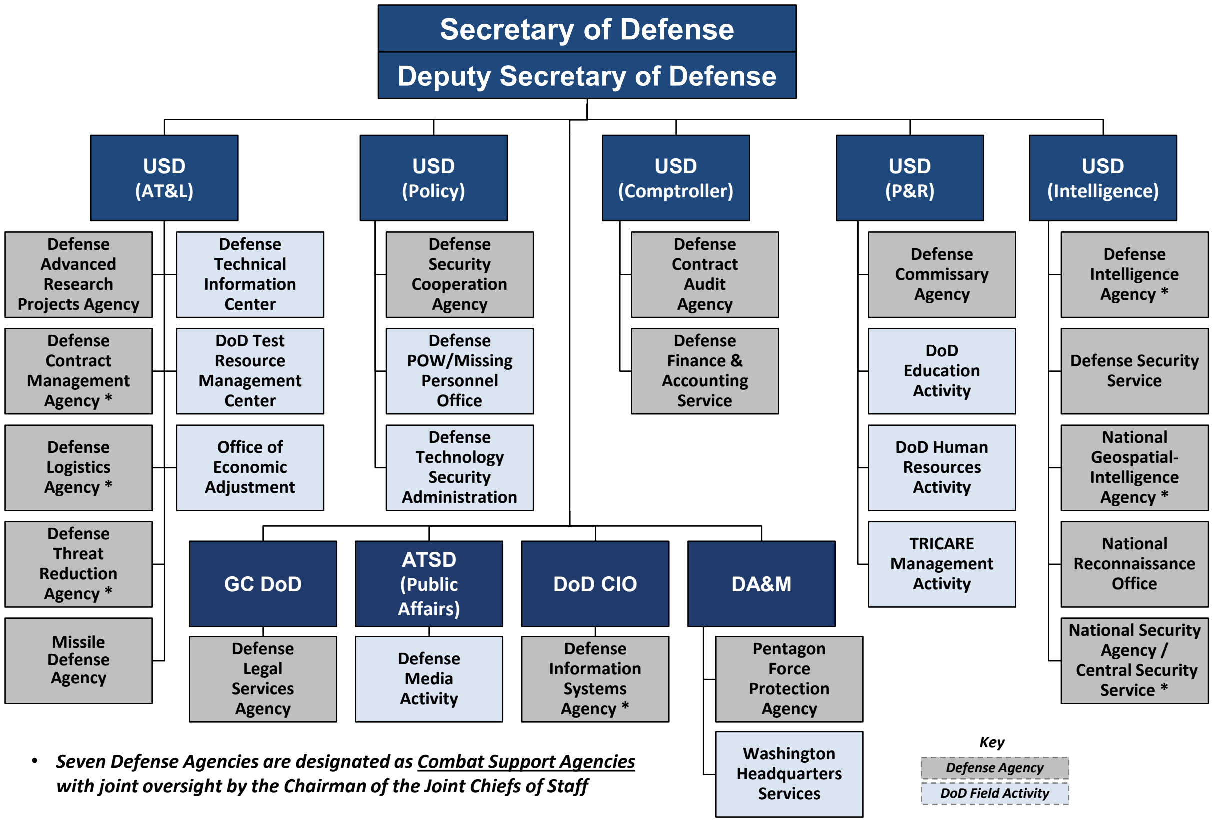


Military Departments include Active and Reserve Components. The Active Component is composed of units under the authority of the Secretary of Defense manned by active duty Military Service members, Reservists on active duty orders, or a combination of the two. The National Guard has a unique dual mission with both Reserve Component and State responsibilities (see Figure 19). The National Guard, when commanded by the Governor of each state or territory, can be called into action during local, statewide, or other emergencies, such as storms, drought, or civil disturbances (non-Federalized service). When ordered to active duty for mobilization or called into Federal service for national emergencies, units of the Guard are placed under operational control of the appropriate Combatant Commander. The Guard and Reserve forces are recognized as indispensable and integral parts of the Nation's defense and fully part of the applicable Military Department.

Defense Agencies and DoD Field Activities

Defense Agencies and DoD Field Activities are established as DoD Components by law, the President, or the Secretary of Defense to provide for the performance, on a DoD-wide basis, of a supply or service activity that is common to more than one Military Department when it is determined to be more effective, economical, or efficient to do so. Each of the 17 Defense Agencies and 10 DoD Field Activities operate under the authority, direction, and control of the Secretary of Defense, through an OSD PSA or the Chairman of the Joint Chiefs of Staff.

Figure 20. Defense Agencies and DoD Field Activities



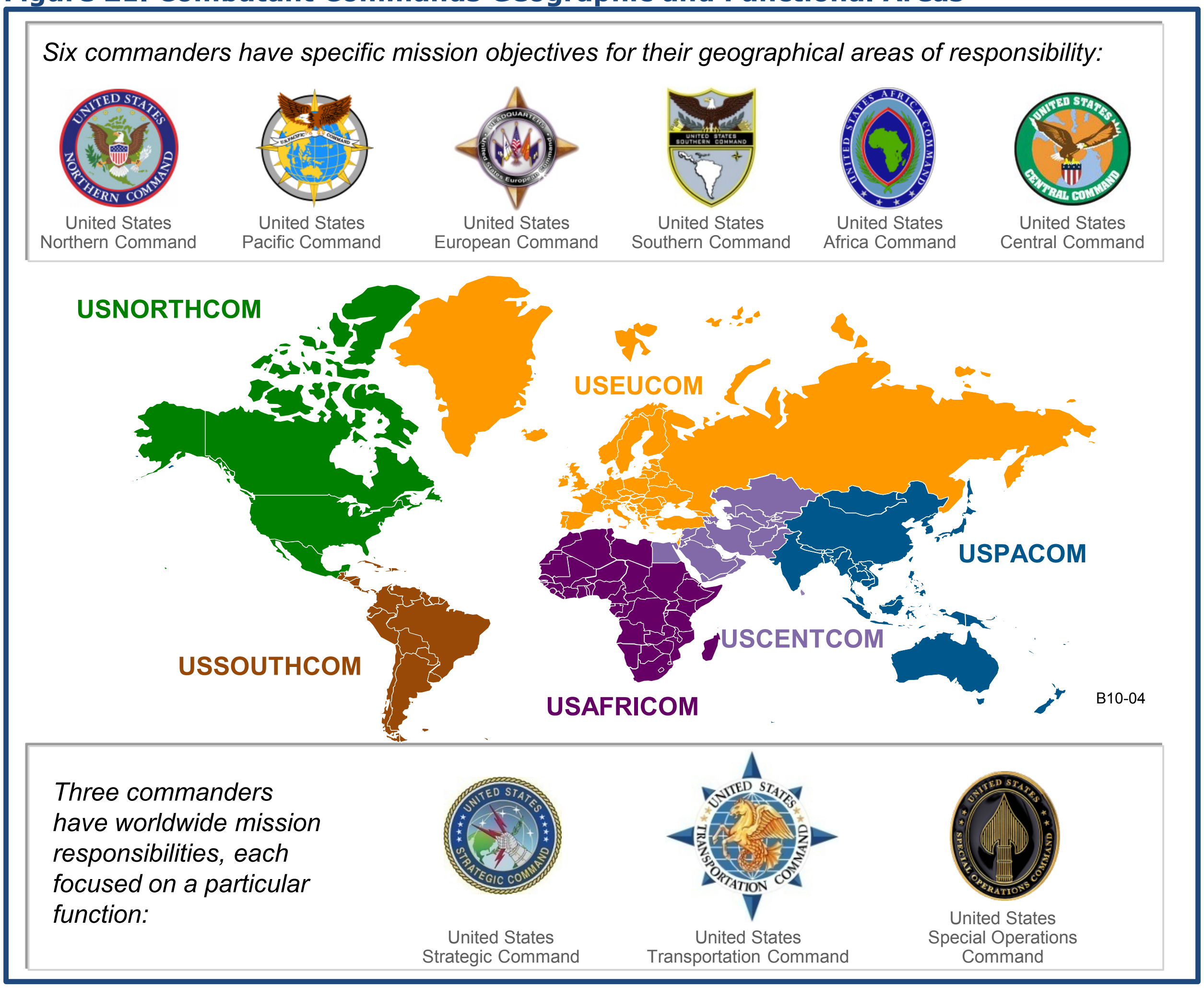
COMBATANT COMMANDS

The Commanders of the Combatant Commands are responsible to the President and the Secretary of Defense for accomplishing the military missions assigned to them and shall exercise command authority over assigned forces as directed by the Secretary of Defense. The operational chain of command runs from the President to the Secretary of Defense to the Commanders of the Combatant Commands. The Chairman of the Joint Chiefs of Staff functions within the chain of command by transmitting the orders of the President or the Secretary of Defense to the Commanders of the Combatant Commands.

The U.S. Special Operations Command (USSOCOM) is a Combatant Command with unique functions, responsibilities, and authorities. These unique functions, responsibilities, and authorities are similar to a number of authorities exercised by the Military Departments and Defense Agencies and include programming, budgeting, acquisition, training, organizing, equipping, and providing special operations forces (SOF), and developing SOF strategy, doctrine, tactics, and procedures. The USSOCOM is reliant upon the Services for common support and base operating support.

In addition to supplying assigned forces and capabilities to the Combatant Commands, the Military Departments provide administrative and logistics support by managing the operational costs and execution of these commands. The USSOCOM is the only Combatant Command that has budget authority provided directly to the Command through Congressional appropriations.

Figure 21. Combatant Commands Geographic and Functional Areas



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